

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF OHIO

IN RE:	*	
	*	CASE NUMBER 01-44007
PHAR-MOR, INC., <i>et al.</i> ,	*	
	*	CHAPTER 11
	*	
Debtors.	*	HONORABLE KAY WOODS
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M E M O R A N D U M O P I N I O N  
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McKesson Corporation ("McKesson") filed McKesson's Motion to Compel Payment of Administrative Expense Claim and Non-Priority Unsecured Claim (the "Motion to Compel Payment") on May 13, 2003. On June 4, 2003, Phar-Mor, Inc. ("Phar-Mor," "Debtor" or "Debtors") filed (A) Debtor's Memorandum in Opposition to McKesson's Motion to Compel Payment, and (B) Debtor's Motion for Reconsideration of Prior Order Regarding Allowance of McKesson Claim Pursuant to Rule 3008 of the Federal Rules of Bankruptcy Procedure ("Phar-Mor's Opposition and Motion for Reconsideration"). On June 9, 2003, McKesson filed McKesson's Reply and Opposition to Phar-Mor's Opposition and Motion for Reconsideration ("McKesson's Reply"). This Court, Chief Judge Bodoh presiding, held a hearing on the Motion to Compel Payment and Phar-Mor's Opposition and Motion for Reconsideration on June 10, 2003. At that time, the Court took the matter under advisement. Judge Bodoh did not render a decision prior to his retirement in early January 2004.

On July 24, 2003, Phar-Mor filed Objection to Proofs

of Claim - McKesson. McKesson filed a Preliminary Response to Objection to Proofs of Claim on August 25, 2003. McKesson filed its Supplemental Brief in Response to Objection to Proofs of Claim on October 14, 2003. No hearing has been held on the Objection to McKesson's claims.

#### **BACKGROUND**

The parties have a long history. Prior to Phar-Mor filing its petition pursuant to Chapter 11 of the Bankruptcy Code on September 24, 2001, McKesson was Phar-Mor's primary source of pharma-ceuticals and over-the-counter drugs pursuant to a supply agreement dated June 19, 1997 (the "Pre-Petition Supply Agreement"). Pursuant to the Pre-Petition Supply Agreement, Phar-Mor owed McKesson between Eighteen Million Dollars (\$18,000,000.00) and Twenty-Two Million Dollars (\$22,000,000.00) in pre-petition receivables. Phar-Mor and McKesson entered into a post-petition supply agreement (the "Supply Agreement"), which provided for the extension of credit by McKesson to Phar-Mor on terms and conditions as set forth therein. The Supply Agreement (at Section 19, subparagraph 4) was specifically conditioned on, among other things:

4. The Court shall have entered an order in form and substance satisfactory to McKesson: (a) designating McKesson as a "critical vendor" of Customers; (b) awarding McKesson an allowed administrative claim (the "Critical Vendor Claim") under Bankruptcy Code § 503(b) with the priority set forth in Bankruptcy Code § 507(a)(1) in an amount of \$4,000,000 on account of McKesson's critical vendor status (which shall be in additional [sic] to and not in lieu

of any administrative claims granted under Bankruptcy Code § 546(c)(2)(A)); provided, that any such Critical Vendor Claim shall be subject to McKesson supplying Merchandise to Customers post-petition as set forth herein; provided that McKesson may terminate this Agreement as a result of a Termination Event other than the Termination Event set forth in Section 17(A)(5) of this Agreement and retain the Critical Vendor Claim notwithstanding McKesson's failure to provide further post-petition Merchandise; (c) providing McKesson with the right to have its Critical Vendor Claim treated as an unsecured claim at McKesson's election (which shall be in McKesson's sole discretion) and (d) providing that the Critical Vendor Claim shall be paid (i) in twelve (12) equal consecutive monthly installments with-out interest commencing on the effective date of a plan of reorganization in the Bankruptcy Cases or (ii) immediately upon the conversion of the Bankruptcy Cases to chapter 7 (unless, in either case, McKesson elects to have the Critical Vendor Claim treated as an unsecured claim pursuant to subsection 4(c) above)[.]

On November 30, 2001, Phar-Mor filed its Motion for Final Order (1) Approving Supply Agreement with McKesson, (2) Authorizing the Debtors to Obtain Credit in Connection Therewith, (3) Granting Various Administrative Claims and (4) Modifying the Automatic Stay (the "Motion to Approve the Supply Agreement"). As justification for approval of the relief it sought, at paragraph 14 of the Motion to Approve the Supply Agreement, Phar-Mor stated:

The Debtors considered various sources of post-petition supply and financing from competitors of McKesson. In the Debtors' reasonable business judgment, the Debtors are unable to obtain the post-petition supply and credit needed to reor-ganize on terms and conditions more favorable to the Debtors than those set forth in the Supply Documents. Moreover, because McKesson was the Debtors' pre-petition supplier, McKesson is already familiar with the

Debtors' operations and the Debtors will not be required to expend significant transition costs in order to implement the Supply Documents.

In addition, paragraph 18 of the Motion to Approve the Supply Agreement stated:

Authorizing the Debtors to proceed with the Supply Documents is in the best interests of the Debtors and their estates. The Debtors will receive a reliable source of Merchandise at reduced prices as well as significant post-petition credit. All of these items will be critical if the Debtors are to reorganize their affairs for the benefit of creditors.

The Motion to Approve the Supply Agreement was unopposed and, on December 13, 2001, the Court entered the Final Order (1) Approving Supply Agreement with McKesson, (2) Authorizing the Debtors to Obtain Credit in Connection Therewith, (3) Granting Various Administrative Claims and (4) Modifying the Automatic Stay (the "Supply Agreement Order"). As part of the relief granted, McKesson was awarded a Four Million Dollar (\$4,000,000.00) Administrative Expense Claim and the Supply Agreement Order provided for the release of McKesson by Debtors, as follows:

Debtors on behalf of their estates and successors hereby irrevocably release and forever discharge McKesson and its respective predecessors, successors, assigns, agents, shareholders, directors, officers, employees, agents, attorneys, parent corporations, subsidiary corporation, affiliates, suppliers, and each of them (collectively, the "McKesson Released Parties"), from any and all affirmative claims, debts, liabilities, demands, offsets, recoupments, obligations, costs, defenses, expenses, actions and causes of action, whether known or unknown, direct or

indirect, arising whether at law or in equity, whether by tort or contract or otherwise, from or related to Bankruptcy Code §§ 544, 545, 547, 548, 549, 550, 551, 553(b), 506(c), 510(c) and 724(a) or any other power under the Bankruptcy Code to impose liability on the McKesson Released Parties. As used herein, the term "claim" is used in its broadest and most comprehensive sense and includes all claims as defined in Bankruptcy Code § 101.

On March 13, 2003, this Court entered the Order Confirming First Amended Joint Plan of Liquidation (the "Liquidation Order"), which provided for the orderly liquidation of Phar-Mor and its affiliated debtors. The Liquidation Order confirmed the First Amended Joint Plan of Liquidation ("Plan"), which provided for the distribution to claimants holding Allowed Claims (as that term was defined). Just prior to the hearing on the Plan, Phar-Mor filed an adversary proceeding against McKesson asserting breach of the Pre-Petition Supply Agreement (the "Breach of Contract Lawsuit"). Phar-Mor moved to withdraw the reference, which was subsequently denied. The Liquidation Order provided at paragraph 18 that McKesson retained any rights and claims it then had, including the right to setoff, entitlement to interest and right to assert counterclaims in connection with the Breach of Contract Lawsuit. Phar-Mor's right to object to any and all of McKesson's rights and claims and counterclaims were also specifically preserved.

#### **THE PARTIES' POSITIONS**

**McKESSON'S POSITION:** McKesson argues that it holds an

allowed administrative expense claim in the amount of Four Million Dollars (\$4,000,000.00) and a general unsecured claim in the amount of at least Eight Million Dollars (\$8,000,000.00) for which Debtors refuse to pay McKesson. McKesson points out that the Supply Agreement Order provides that McKesson holds an allowed administrative priority claim in the amount of Four Million Dollars (\$4,000,000.00) (defined therein as the "Other Administrative Claims"). See paragraph 7 of the Supply Agreement Order. This Order requires that the Other Administrative Claims be paid in twelve (12) equal consecutive monthly installments without interest commencing on the effective date of a plan of reorganization. See paragraph 8 of the Supply Agreement Order. McKesson also notes that Debtors' Plan requires payment of all Allowed Administrative Claims and allowed unsecured claims. Despite the Supply Agreement Order, the Confirmation Order and repeated requests for payment by McKesson, McKesson states that Phar-Mor has refused to pay on McKesson's administrative claim.

McKesson further contends that Phar-Mor failed to include McKesson in the claims made on the Initial Distribution Date of April 13, 2003, when Phar-Mor tendered a seven percent (7%) distribution to holders of allowed unsecured claims. Despite its status as a holder of an allowed unsecured claim, McKesson states that no distribution was made to McKesson.

In response to its request for payment, McKesson states that it received a letter from counsel for Phar-Mor dated May 2,

2003, which stated:

The validity of the [Administrative Expense Claim] is in dispute for reasons which include the rights of set-off which Debtor believes exist relating to the adversary proceeding now pending before the Bankruptcy Court. In addition, the validity of the underlying transaction appears subject to challenge based upon the District Court's decision in *Capital Factors, Inc. v. Kmart Corporation*, 2003 WL 1868753 (N.D. Ill). Please be guided accordingly.

McKesson argued that (at that time) Debtors had not challenged the claim or sought to set off McKesson's claims.<sup>1</sup> McKesson further contends that the *Kmart* decision has no applicability to McKesson's allowed administrative claim because (1) it is not binding on this Court; and (2) the Supply Agreement Order is a final non-appealable order that cannot be collaterally attacked.

McKesson also argues that it is entitled to post-confirmation interest and attorney fees because of Phar-Mor's refusal to pay its administrative expense claim.

In its Reply, McKesson further states that Phar-Mor does

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<sup>1</sup>Phar-Mor subsequently filed its Objection to McKesson's proofs of claim on July 24, 2003. The Plan required that all objections to claims had to be filed within 90 days of the Effective Date of the Plan, which 90-day time period could be extended automatically by Debtors for 30 days without further application or order of the Court and could be further extended another 30 days with the consent of the Committee, which consent was not to be unreasonably withheld. The exact date for the Effective Date is not clear from the face of the Plan, the Confirmation Order or the docket. The Confirmation Order was entered on March 13, 2003. Phar-Mor filed its Objection to McKesson's claims on July 24, 2003, which is 133 days after the date of entry of the Confirmation Order. The Plan defines the Effective Date as a date to be selected by the Plan Proponents as soon as reasonably practical after the conditions in § 1.1 were satisfied or waived. The Court is not clear what date constitutes the Effective Date or if the 90-day period was extended by consent of the Committee, but since the Objection to McKesson's claim was not challenged as being untimely, the Court assumes that it was timely filed.

not possess any setoff rights because any such rights were vitiated by the Supply Agreement Order and the Confirmation Order. McKesson argues that Phar-Mor never sought permission from the Court to be excused from fulfilling its contractual obligations to McKesson, but rather Debtor made an improper unilateral decision not to pay McKesson. McKesson further notes that Phar-Mor failed to assert any right to setoff in the Breach of Contract Lawsuit. Last, McKesson argues that § 558 does not confer upon Debtor a unilateral right to impose a setoff, but any such right must be done pursuant to Bankruptcy Rule 3007. McKesson further notes that the Supply Agreement Order specifically bars a collateral attack on the Other Administrative Claims and cites paragraph 15 of the Order, which provides: "Each Debtor irrevocably waives any right to seek any modifications or extensions of this Order or any of the Supply Documents from this Court without the prior written consent of McKesson, and no such consent shall be implied by any other action, inaction or acquiescence by McKesson."

McKesson attacks the Motion for Reconsideration on procedural grounds and also argues that there is no cause for such reconsideration and no justification for Phar-Mor's delay in seeking reconsideration.

**PHAR-MOR'S POSITION:** In opposition, Phar-Mor argues that it has the right to suspend any payment to McKesson pending resolution of the Breach of Contract Lawsuit. Phar-Mor argues that the release language in the Supply Agreement Order operates only



as a release of affirmative defenses and not negative defenses such as its right to setoff, as asserted in the Breach of Contract Lawsuit. As a consequence, Phar-Mor argues that the issue of whether the language in paragraph 13 of the Supply Agreement Order would bar Debtors from seeking affirmative relief against McKesson in excess of the Twenty-One Million Dollars (\$21,000,000.00) of outstanding indebtedness alleged to be owed to McKesson only becomes relevant to the extent that Debtor obtains a verdict in the Breach of Contract Lawsuit in excess of Twenty-One Million Dollars (\$21,000,000.00). Additionally, Phar-Mor argues that the release language is limited to claims arising from §§ 544, *et seq.* of the Bankruptcy Code and, thus, cannot be expanded by McKesson to include the Breach of Contract Lawsuit, which is based on applicable state law rather than the Bankruptcy Code.

Moreover, Phar-Mor argues that cause exists, pursuant to Bankruptcy Rule 3008, for the Court to reconsider the prior allowance of a portion of McKesson's general unsecured pre-petition trade claim as the Four Million Dollar (\$4,000,000.00) Other Administrative Claims. Rule 3008 provides that: "A party in interest may move for reconsideration of an order allowing or disallowing a claim against the estate. The court after a hearing on notice shall enter an appropriate order." Accordingly, Phar-Mor moved the Court for such reconsideration, relying on § 502(j) of the Bankruptcy Code, which provides that: "A claim that has been allowed or disallowed may be reconsidered for cause. A

reconsidered claim may be allowed or disallowed according to the equities of the case . . . ." Phar-Mor contends that the equities of the case dictate that McKesson is not entitled to an administrative claim for any portion of its pre-petition general unsecured trade claim and that the prior allowance of such portion as a "critical" vendor administrative claim should be reconsidered. Phar-Mor asks the Court to balance the equities and consider that Phar-Mor paid McKesson more than One Hundred Ninety-One Million Dollars (\$191,000,000.00) post-petition for merchandise and that, although Debtors did business with more than one thousand (1,000) vendors, only McKesson was able to utilize its disparity in bargaining power to obtain a critical vendor administrative expense claim.

#### **THE MOTION FOR RECONSIDERATION**

Although it was not the first motion to be filed, the Court must first dispose of the Motion for Reconsideration of the Four Million Dollar (\$4,000,000.00) Other Administrative Claims. It is imperative to first establish whether or not McKesson has an allowed administrative expense claim before its Motion to Compel Payment can be addressed.

In addition to the arguments set forth by the parties in their papers, the parties argued this issue at the June 10, 2003 hearing.<sup>2</sup> At the hearing, counsel for Phar-Mor argued that a

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<sup>2</sup>The Court listened to the CD of the entire proceeding held before Judge Bodoh on June 10, 2003 and heard all of the arguments of counsel. Judge Bodoh left no notes of his impressions from that hearing, but this Court is able to make a

motion pursuant to Bankruptcy Rule 3008 can be substituted for a motion pursuant to Federal Rule of Civil Procedure 60(b) while recognizing that the two motions are not identical. Phar-Mor urged the Court to recognize that approval of the post-petition Supply Agreement and allowance of the Other Administrative Claims as a critical vendor claim were separate and distinct. As a consequence, even though a court order created the Four Million Dollar (\$4,000,000.00) Other Administrative Claims, it still constituted a claim that could be reconsidered pursuant to § 502(j) of the Bankruptcy Code. McKesson countered that the Four Million Dollar (\$4,000,000.00) claim did not stand alone and could not be reconsidered absent a motion, pursuant to Federal Rule of Civil Procedure 60(b), that sought relief from the entire Supply Agreement Order. McKesson argued that the Supply Agreement provided Phar-Mor with most favored nation pricing, among other things, and that all issues relating to the Supply Agreement and the extension of credit would have to be reopened if Phar-Mor wanted the Court to reconsider allowance of the Four Million Dollar (\$4,000,000.00) claim. McKesson insisted that an evidentiary hearing would be necessary to determine what would have happened in the absence of court approval of the post-petition Supply Agreement, with the court considering all issues, not just the allowance of the Other Administrative Claims.

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decision on all matters set forth on the papers and argued before the Court, based on its thorough review of the docket, the pleadings, the oral transcript of the hearing, and subsequent telephonic status conference with the parties.

This Court holds that the Supply Agreement Order is a final order that encompassed many related subjects, not just the allowance of an administrative claim. In the Supply Agreement Order, Debtors sought and obtained approval of the Supply Agreement and authorization to obtain credit and modification of the automatic stay, in addition to allowance of various administrative claims (not just the Other Administrative Claims). Case law provides that the standard for reconsidering a claim are the same as under Federal Rule of Civil Procedure 60(b). See *In re Harbor Financial Group, Inc.*, 303 B.R. 124, 131 (N.D. Texas 2003) ("When determining whether 'cause' exists to reconsider a claim, courts generally apply the standards set forth in Federal Rule of Civil Procedure 60(b), incorporated by Bankruptcy Rule 9024.") and *In re Thompson*, No. 90-81234, 1993 Bankr. LEXIS 1954, at \*5-6 (C.D. Ill. Apr. 19, 1993) ("Thus, a creditor must assert fraud, newly discovered evidence, mistake, excusable neglect, or any of the other matters pertinent to a Fed. R. Civ. P. 60(b) motion to assert 'cause' for reconsideration under Code § 502(j). [The Advisory Committee note to Bankruptcy Rule 3008 states that reconsideration of a claim is discretionary with the court. Reconsideration is not discretionary for Code § 502(j) provides that reconsideration may be only for cause.]"). As a consequence, in order to prevail on its motion for reconsideration that no portion (specifically, the Four Million Dollar (\$4,000,000.00) Other Administrative Claims) of McKesson's pre-petition unsecured trade claim should be allowed

as an administrative expense claim under the "critical" vendor theory, Phar-Mor must allege (and establish) that it is entitled to recon-sideration of the claim on the basis of mistake, inadvertence, surprise, or excusable neglect; newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; or any other reason justifying relief, as set forth in Federal Rule of Civil Procedure 60(b).

Phar-Mor has not alleged any of the bases in Federal Rule of Civil Procedure 60(b) for reconsideration of McKesson's Other Administrative Claims. Phar-Mor contends:

there is no question that McKesson's asserted \$4 million dollar administrative expense claim originated as a prepetition general unsecured trade claim against the Debtor, and was only elevated to administrative expense status based upon McKesson's assertion of its status as a critical vendor. Specifically, McKesson obtained such status for a portion of its prepetition general unsecured claim as a result of an uncon-tested supply order presented to the Court.

See page 7 of Phar-Mor's Opposition and Motion for Reconsideration. What Phar-Mor ignores, however, is that McKesson wasn't alone in asserting that it had status as a critical vendor and that it was Phar-Mor's motion that was uncontested. Indeed, Phar-Mor represented to this Court that it had tried to obtain post-petition credit from competitors of McKesson, but had been unable to do so

on as favorable terms. Phar-Mor urged that approval of the Supply Agreement, which included as a condition precedent the allowance of the Four Million Dollar (\$4,000,000.00) administrative claim, was "critical" to Debtor's ability to reorganize. Phar-Mor further urged that approval of all of the relief sought in the Motion to Approve the Supply Agreement was in the best interests of Debtors, their creditors and the estates. Phar-Mor now takes exception to the fact that McKesson was able to leverage that it was critical to the survival of Debtor, when Phar-Mor was not only aware of that fact at the time it moved the Court for approval of the Supply Agreement, but it relied on those circumstances to justify the allowance of the Other Administrative Claims in the amount of Four Million Dollars (\$4,000,000.00).

Phar-Mor now relies on the *Kmart* decision as justification for this Court to revisit the allowance of the Other Administrative Claims, but this Court declines to do so. The facts and circumstances in the *Kmart* case are dramatically different from the facts underlying the Supply Agreement Order. Phar-Mor states that

[t]he issue before this Court is straight forward. Do the equities favor the reconsideration of McKesson's \$4 million dollar administrative expense claim? The Debtor believes that the equities clearly lie in favor of the general unsecured creditors of the Debtor, particularly since McKesson sold, and was paid in full for, nearly \$200 million dollars of product after the Debtor filed its petition for relief.

See page 10 of Phar-Mor's Opposition and Motion for Reconsideration. On this basis, Phar-Mor's Motion for Reconsideration of the claim must be denied. In seeking approval of the Supply Agreement, Phar-Mor itself represented that it could not obtain more favorable rates from any of McKesson's competitors. Phar-Mor claimed that the Supply Agreement would result in a "reliable source of Merchandise at reduced prices as well as significant post-petition credit." See paragraph 18 of Motion to Approve Supply Agreement. Furthermore, Phar-Mor argued that approval of the Supply Agreement would save it from expending "significant transition costs." See paragraph 14 of Motion to Approve Supply Agreement. In other words, Phar-Mor previously represented to the Court, the Committee, and its creditors, that the Four Million Dollar (\$4,000,000.00) administrative expense claim was justified because it was getting a better deal under the Supply Agreement than it could get anywhere else. The fact that McKesson performed and was paid (even though it was nearly Two Hundred Million Dollars (\$200,000,000.00)) pursuant to that approved Supply Agreement provides no justification - equitable or otherwise - to now reconsider the allowance of the Four Million Dollar (\$4,000,000.00) administrative claim that was part and parcel of the Supply Agreement.

As a consequence, the Court denies Phar-Mor's motion for reconsideration of the Four Million Dollar (\$4,000,000.00) Other Administrative Claims and finds that McKesson has an Allowed Admin-

istrative Claim in the amount of Four Million Dollars (\$4,000,000.00).

**THE MOTION TO COMPEL PAYMENT**

McKesson cites two prior orders of this Court that it main-tains mandate payment of its claims - the Supply Agreement Order and the Confirmation Order. Phar-Mor does not appear to dispute that these orders require the payment of allowed claims, but instead argues that it has objected to McKesson's claims and that it is entitled to suspend payment until the Breach of Contract Lawsuit is resolved. Phar-Mor contends that it has not released the claims it asserts against McKesson in the Breach of Contract Lawsuit and, as a conse-quence, Phar-Mor states that the release only becomes relevant if it obtains a judgment on the Breach of Contract Lawsuit in excess of the Twenty-One Million Dollars (\$21,000,000.00) claimed by McKesson. Phar-Mor asserts in its Objection to McKesson's Claims that it "reserves all rights to obtain setoff, recoupment, and/or a claim for affirmative relief to the extent it is successful in obtaining the relief sought" in the Breach of Contract Lawsuit. See page 2 of the Objection to McKesson's Claims.

McKesson counters that Phar-Mor is not entitled to any kind of a setoff against McKesson's allowed claims. In McKesson's Supple-mental Brief in Response to Phar-Mor's Objection, McKesson sets forth a detailed analysis of the right of setoff and concludes that Phar-Mor does not have any setoff rights because (1) there is



no right under Ohio law, which requires: (a) mutuality of debt, (b) that there be two independent contracts, and (c) that the indebtedness be definite instead of contingent; and (2) there is no right to assert setoff under § 553 of the Bankruptcy Code, which requires: (a) pre-petition debts, (b) mutuality, and (c) a right to setoff under nonbankruptcy law. McKesson argues that there is no mutuality because it holds a post-petition administrative claim against Debtor and that it is "questionable whether the Debtor holds a valid pre-petition claim against McKesson." See page 11 of McKesson's Supplemental Brief.

Setoff and recoupment are similar, but different doctrines. Setoff requires mutuality of debt. Recoupment, however, arises out of the same transaction.<sup>3</sup> Both doctrines are applicable in bankruptcy.<sup>4</sup> The main distinction between recoupment

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<sup>3</sup>"For recoupment to apply, however, the creditor must have a claim against the debtor that arises from the *same transaction* as the debtor's claim against the creditor." *Bird v. Carl's Grocery Co. (In re NWFx, Inc.)*, 864 F.2d 593, 597 (8th Cir. 1989) (citing *Ashland Petroleum Co. v. Appel (In re B & L Oil Co.)*, 782 F.2d 155, 157 (10th Cir. 1986) (emphasis added)).

<sup>4</sup>The recoupment doctrine is applicable in bankruptcy. *Sheehan v. Wiener (In re Wiener)*, 228 B.R. 647, 650 (Bankr. N.D. Ohio 1998) (citing *Reiter v. Cooper*, 507 U.S. 258, 265 n.2 (1993)). Setoff is specifically set forth in § 553 of the Bankruptcy Code, which preserves certain rights of setoff that exist under applicable nonbankruptcy law. Section 553(a) provides, in relevant part:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that--

. . . .

11 U.S.C. § 533(a).

and setoff is that setoff is a form of cross action that depends on the existence of two separate, mutual obligations; whereas, recoupment is like a compulsory counter-claim in that the obligations must arise out of the same transaction. See 5 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 553.10 (15th ed. 2003).

To the extent Phar-Mor is attempting to setoff any damages it may be awarded in the Breach of Contract Lawsuit against the Four Million Dollar (\$4,000,000.00) Other Administrative Claims, this Court agrees with McKesson that there is no mutuality, and, thus, no right to setoff. Phar-Mor has alleged a pre-petition breach of contract in the Breach of Contract Lawsuit. Even if Phar-Mor is successful, any judgment in the Breach of Contract Lawsuit, which relates to pre-petition conduct, cannot be setoff against an allowed administrative (post-petition) claim.

It is indisputable here that McKesson's pre-petition claims arise out of the same transaction, *i.e.*, the Pre-Petition Supply Agreement, that is the subject of Phar-Mor's Breach of Contract Lawsuit. As a consequence, if Phar-Mor has a right to recover on its Breach of Contract Lawsuit, it can assert recoupment against the amounts owed to McKesson on its pre-petition general unsecured claims.

Accordingly, this Court holds that McKesson is entitled to payment on its Allowed Other Administrative Claims in the amount of Four Million Dollars (\$4,000,000.00), consistent with the Supply Agreement Order. Since payment should have been made in twelve

(12) equal consecutive monthly installments without interest commencing on the Effective Date (*i.e.*, some time in the summer of 2003), Phar-Mor is directed to pay McKesson the entire Four Million Dollar (\$4,000,000.00) Other Administrative Claims immediately, plus such interest, if any, that has accrued on this amount in the Reserve Account (for disputed claims). Phar-Mor shall not be required to make a *pro-rata* distribution on McKesson's general unsecured claims until there is (1) a final determination with respect to the Reclamation Claim and (2) an adjudication in the Breach of Contract Lawsuit. Phar-Mor is entitled to recoup the amount, if any, it may be awarded in the Breach of Contract Lawsuit before making a distribution to McKesson on its general unsecured claims.

#### **OBJECTION TO MCKESSON'S CLAIMS**

As previously set forth, Phar-Mor's objection to and request for reconsideration of the Four Million Dollar (\$4,000,000.00) Other Administrative Claims is overruled and denied. Phar-Mor continues to object to McKesson's Reclamation Claim in the approximate amount of Eight Million Six Hundred Thousand Dollars (\$8,600,000.00). It is this Court's understanding that certain issues<sup>5</sup> regarding the Reclama-

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<sup>5</sup>This Court understands that the District Court appeal involves the issue of whether the status as a secured creditor deprives a creditor of the ability to reclaim goods. A second issue regarding whether Phar-Mor was insolvent at the time the goods were delivered, as required by § 546(c), has never been addressed by this Court. Additionally, no other defenses to the Reclamation Claim have

tion Claim are currently on appeal to the United States District Court. Phar-Mor also objects to McKesson's general unsecured claim in the approximate amount of Eight Million Five Hundred Thousand Dollars (\$8,500,000.00). Phar-Mor objects to the amount of the general unsecured claim as well as payment of such claim until after the Breach of Contract Lawsuit is resolved.<sup>6</sup> As set forth above, Phar-Mor is relieved from making a distribution on the general unsecured claim until the Breach of Contract Lawsuit is resolved. A further hearing will be held on the Objection after briefing is complete.

An appropriate order shall enter.

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**HONORABLE KAY WOODS**  
**UNITED STATES BANKRUPTCY JUDGE**

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been presented to or heard by this Court.

<sup>6</sup>The parties are in the process of briefing the issues of dispute relating to the Objection.

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF OHIO

IN RE:

PHAR-MOR, INC., *et al.*,

Debtors.

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CASE NUMBER 01-44007

CHAPTER 11

HONORABLE KAY WOODS

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For the reasons set forth in this Court's Memorandum Opinion entered this date, Phar-Mor's Opposition and Motion for Reconsideration of the Four Million Dollar (\$4,000,000.00) Other Administrative Claims is overruled and denied. McKesson's Motion to Compel Payment is granted. McKesson is entitled to immediate payment on its Allowed Other Administrative Claims from Phar-Mor in the amount of Four Million Dollars (\$4,000,000.00), plus the interest, if any, on such claim that has accrued in the Reserve Account.

IT IS SO ORDERED.

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HONORABLE KAY WOODS  
UNITED STATES BANKRUPTCY JUDGE

**CERTIFICATE OF SERVICE**

I hereby certify that a copy of the foregoing Memorandum Opinion and Order were placed in the United States Mail this \_\_\_\_\_ day of August, 2005, addressed to:

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JOANNA M. ARMSTRONG